



★★ U.S. SECURITIES & EXCHANGE COMMISSION ★★
DIVISION OF TRADING AND MARKETS

February 27, 2008

MEMORANDUM

TO: Erik Sirri, Director
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FROM: Raymond Doherty, Branch Chief
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SUBJECT: Scope Memorandum for the Consolidated Supervised Entity ("CSE") Commercial Real Estate ("CRE")¹ Price Verification Inspections

This memorandum outlines the scope for the inspection of the CRE price verification process at the five CSEs. In determining the scope of this inspection, the staff held discussions with the Division of Trading and Markets' Risk Monitors, as well as representatives from the CSEs. Additionally, the staff has reviewed firm-specific written policies and procedures as they relate to the price verification of CRE valuations.

Background

The staff will inspect all five CSEs beginning with Lehman Brothers and Goldman Sachs. The inspections will focus on (1) gaining a general understanding of the CRE products held in inventory by the CSE firms, including the related hedging strategies, (2) reviewing the price verification policies and procedures to determine if appropriate valuation controls have been designed, and (3) testing the price verification process to ensure that the controls are operating as intended. Ultimately, the staff will compare and contrast the various CRE-related price verification policies and procedures across the five CSEs.

1. Business Overview

The staff will meet with each firms' product controllers and/or risk managers to discuss detailed inventory positions and to enhance our general understanding of each firms' CRE business activities. The staff will use this information in selecting samples for the price verification review. Inventory samples will be selected based upon materiality, perceived pricing challenges, aging, and other potential risk factors identified by the inspection staff and Risk Monitors, and will include a cross-section of the CRE business activities.

¹ CRE related products include, but are not limited to, fixed and floating rate whole loans, commercial mortgage-backed securities, bridge equity, and related derivatives.

2. Policies and Procedures

The staff will review each of the CSE firm's policies and procedures for the price verification of CRE related products. The staff will evaluate the policies and procedures, including the underlying approach to independently verifying the valuations of various CRE assets. Important elements of this approach include the use of pricing models, identification of pricing variances, escalation requirements, documentation, and organizational independence. An emphasis will be placed on procedures applicable to those assets that have limited price transparency. The staff will also determine how the price verification process evolved in response to recent market events.

3. Price Verification Testing

The staff will obtain a listing of each firm's CRE assets for the review period and select products to review based upon the previously described criteria (*e.g.*, materiality, aging, etc.). The staff will walk through the month-end reconciliation process and the price verification documentation for the selected sample and compare the process, controls, and documentation to established policies and procedures. An emphasis will be placed on pricing model inputs and assumptions, which will be validated to third-party sources when available. The staff will also evaluate the degree of organizational independence reflected in the price verification process.

cc: Phil Minnick